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Economic Report

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Commentary on Pertinent Economic Issues

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Random Thoughts

If you're like me, you tend to get caught up in the day-to-day flow of events, many times losing sight of the bigger picture. Too often, these days, we economists spend most of our time waiting for the latest statistic, and/or news item, then rush to come up with an "instant analysis" that fits into a 10-second sound bite on the air, or a pithy quote for the daily newspapers. Many are so immersed in the daily ebb and flow of the data that they literally are unable to see the forest for the trees.

Never has minute-by-minute minutia been more closely scrutinized than today. Economists, businessmen, consumers—and, of course, elected officials—have begun a recovery watch, unsure of whether the economy has emerged from recession or not, and if so, how fast it is likely to add to profits and jobs. And, speaking of elected officials, since 1992 is a year divisible by four, politicians from both major parties are not only examining the data—they are pontificating with increasing intensity, hoping to come up with the program that gets them elected this November.

Everyone needs a break once in a while, so in the interest of helping all of us retain our sanity, I am offering this month, not another update of where we are and where we are going, but some thoughts on several issues that have tended to be overlooked by press and pundits alike.

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Where's The Umpire?

As many of you know, the official arbiter of the business cycle is an organization called the National Bureau of Economic Research. Like an umpire in a baseball game, the NBER stands between two sides, in this case, between economists in the private sector and those in Washington. Also like an umpire, its decisions are respected by both sides and are final. However, unlike what happens in a baseball game, the NBER doesn't render its decision immediately; it usually waits until enough data are in, and this can take many months.

Case in point: The NBER waited until April 1991 before deciding that America's ninth postwar recession got underway in August 1990. Interestingly, April 1991 may well have been the month when that recession ended. For you see, the gross domestic product, the all-encompassing measure of economic activity within the United States, stopped declining at that time, and has been rising ever since. The GDP, adjusted for inflation, grew at an annual rate of 1.4 percent in 1991's second quarter, 1.8 percent in the third, and 0.4 percent in the fourth.

Now the NBER will be the first to tell you that dating a business cycle's beginning and end involves more than just looking at the gross domestic product, and I agree. However, unless the umpire has changed his definition of what constitutes a recession, then the time has come for the NBER to declare that the recession that began in summer 1990, ended sometime in early 1991. For never in the past has a recession included two consecutive rising quarters of GDP, much less the three already recorded.

Such a declaration would be of no small significance. One of the biggest hurdles confronting the nascent recovery is a distinct lack of confidence on the part of both businessmen and consumers. This is keeping both from spending more, which, of course, is what's needed, if the recovery is to develop momentum and spread throughout the economy. It is not enough for the President, or any other politician with a vested interest in boosting confidence, to say that the recession has ended; people simply wouldn't believe them anymore than they believed Herbert Hoover when he said "prosperity is right around the corner." However, such a declaration from the non-partisan NBER might be enough to boost morale—and outlays.

Losing Confidence

Not long ago, the Conference Board's respected survey of consumer confidence—presumably a harbinger of future spending—touched its lowest point in over 17 years. Some of the more pessimistic pundits seized upon this reading as a sign that the recession not only didn't end last year, but that it would continue for many months to come. While there no doubt are good reasons for people to feel depressed—especially those who have either lost their jobs or are running harder just to keep up with the rising cost of living—it is inconceivable to me that Americans in the aggregate are so blue.

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Let me remind you what was going on 17 years ago, in December 1974, when confidence was last as low as the Board's February 1992 reading. For one thing, the country was reverberating from the resignation of a President three months earlier—something that had never happened before in our history. Then there was the "oil shock"; soaring prices for oil and gasoline; lines at the pumps; double-digit inflation and interest rates; a credit crunch; falling stock prices; and the "cold war" with the Soviet Union.

Let's look at the situation that existed this past February. The "cold war" was over; the Soviet Union dissolved; oil and gasoline prices had fallen over 25 percent since October 1990; interest rates at quarter-century lows; and a soaring stock market. Hardly reason for people's moods to be so blue, it seems to me. On the other hand, people are concerned that the value of their homes—their biggest asset—has fallen, that many of the jobs that are being lost these days are gone forever, not to return when the economy strengthens, and that elected officials do not appear to have either a realistic plan and/or the ability to address these concerns.

Why Do We Have Business Cycles?

Readers no doubt know that this past recession has had numerous predecessors. The NBER counts eight since the end of World War II, and a total of 30 since 1854 for the United States. Undoubtedly, there have been others, if the experience of England is any guide. Because data here go back further—even before the U.K. became an industrialized country—it is possible to surmise that business cycles are quite a long-standing feature of almost any society.

The next question is why do these cycles occur? It appears to me as though they can basically be traced to human nature. In the pre-industrial days, when agriculture was the main industry, the occasional bouts of poor growing weather would affect crop production, causing scarcities. In turn, farmers would find that supplies fell short of demand. Someone got the notion that if he could sell all his crops and then some at the prevailing price, why not ask for more, as long as demand exceeded supplies? From this was born inflation, which would proceed until enough people were priced out of the market to necessitate a lowering of prices. Naturally, this involved pain.

As countries became industrialized, and people went to work for others, this attitude went with them. When demand for workers exceeded the supply, labor would tend to ask for more. This pinched business earnings unless matched by a hike in selling prices. Once again, inflation proceeded until buyers were priced out of the market. Business sales would fall, workers would lose their jobs, and prices would decline until market equilibrium was restored.

In modern times, as governments grew and central banks were formed, policy errors tended to add to the ups and downs of business. Responding to pressures from their constituents, elected officials would increase Government spending and/or lower taxes. The central bank (in our case, the Federal Reserve) would respond to the resulting increase in economic activity and the demand for funds by creating additional supplies of money and credit. This eventually led to inflation, since demand once more exceeded supplies. In response, fiscal policy would tighten as Washington either raised taxes and/or slashed spending. For its part, the Fed would tighten monetary policy by slowing the growth of the money supply, thus pushing up interest rates. The result, of course, was enough of a softening of business activity to dampen price pressures—in other words, a recession. When the pain of recession became intolerable, policymakers would reverse course—usually overdoing it in the process—resulting in an end to the recession, but the beginnings of the next round of inflation.

Up And Down

Looking at how the most recent recession developed, and the way in which it ended, the thought occurred to me that if prices of goods and services were to fall when demands weakened the way the price of money (interest rates) does, future recessions might be milder, and the subsequent recoveries a bit stronger. As you might imagine, the very fact that interest rates do decline is the basis for the ability of monetary policy to cushion the blow of a recession. The reduced cost of borrowing makes it worthwhile for some to borrow while permitting others to refinance an existing loan at a lower cost. Both eventually lead to increased spending.

In this past recession, prices of many items did fall, witness the year-over-year declines in the Labor Department's producer price index since the fourth quarter of last year. In particular, prices of commercial and industrial real estate fell, with the resulting decline in rents encouraging many to rent new or additional space. This was also reflected in lower prices for homes, leading to a significant jump in sales of both new and existing homes, and a consequent jump in new-home construction.

Needless to say, these developments have laid the foundation for faster economic growth. Increased residential construction activity obviously boosts the demand for real estate, labor and building materials. More homes purchased and/or commercial space rented leads to a greater need for such items as furniture, home appliances, fixtures and floor coverings, to name a few. As these items are bought and sales rise, the demand ripples back to the manufacturers of these goods, who, naturally will produce more, increasing their own demands for labor, materials, etc.

In the past, prices tended to be sticky—and most still are. Business obviously does not want to cut prices unless its costs fall. Labor rarely makes wage concessions unless the demand for workers falls significantly. And such other business costs as taxes seem to go only in one direction, and that's up. However, if prices don't respond to changed economic conditions, you wind up with a situation such as that faced by the automobile industry. For years, carmakers have raised their prices faster than the incomes of their prospective buyers. Twenty years ago, the average new car cost less than 17 weeks of the average family's income. Today, it's more like 25 weeks. Not surprisingly sales of all new cars have failed to keep up with population growth.

One way to make prices more flexible might be to change the way labor is compensated. Business might pay a base salary, then add a bonus if sales are strong. When sales soften, that bonus might shrink or even disappear. This would not only lower labor costs—usually two-thirds of the typical firm's costs—it might also keep more people employed, since companies wouldn't have to cut payrolls in order to reduce their wage bills. This, too, would help moderate recessions, since aggregate worker purchasing power would not drop as much as it would were unemployment to rise. And, of course, confidence would hold up as well.

Fiscal Scare

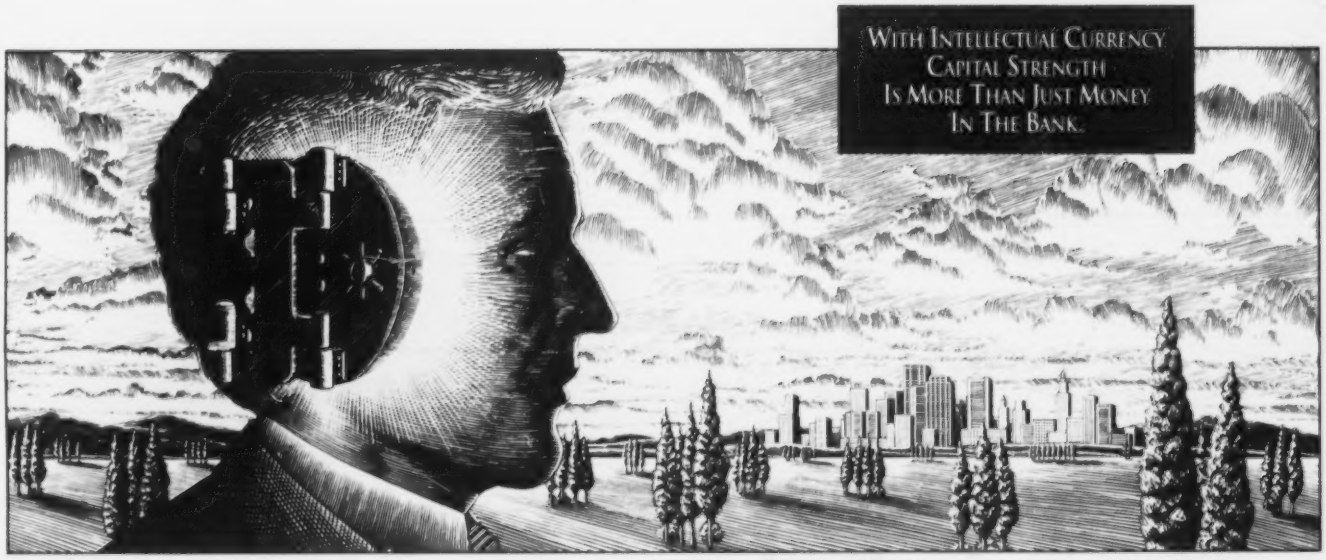
Getting back to one of the points I made earlier, one of the reasons why people are so depressed these days is a belief that the economy needs help, and that Washington is powerless to do very much about it. To be sure, politicians from both major parties have proposed legislation to help move economic activity into higher gear. However, with the Government's budget deficit headed toward $400 billion this year, few think much can be expected from fiscal policy. Indeed, more than a few economists are recommending that whatever legislation does emerge be deficit-neutral. In other words, what Washington might give with one hand, it should take with the other. Some stimulus!

The huge deficit is not only rendering fiscal policy impotent, it is also keeping interest rates on medium- and long-term instruments high. And the accumulation of all the deficits of years past is preventing the Treasury from utilizing flexible debt management techniques. This year, by its own reckoning, the Government will have to borrow over $630 billion—a sum so staggering it is equal to more than twice the savings that the U.S. economy is expected to generate this year. By contrast, in 1960, a budget surplus year, the Government borrowed only $5 billion, representing less than 14 percent of that year's savings. As you might imagine, interest rates were much lower then than they are today.

Most of these funds will have to be raised in the medium- and long-term debt markets, where, unfortunately, rates are the highest. However, as noted in the February issue of this Report, the Treasury has little choice, given how much debt has to be financed. Needless to say, these cash needs, combined with the needs of such other countries as Germany, and the reduced inflow of funds from Japan, spell even higher long-term rates, thus a threat to housing, and, eventually, to the rest of the economy.

Right now, there isn't too much that can be done to reduce the deficit. However, once business picks up, we will have another opportunity to reduce the deficit once and for all, so that the next time the economy goes into a recession (and there will be a next time; remember the reference above to human nature and policy errors), fiscal policy can join monetary policy to soften the blow.

Of course, elected officials only respond to what they believe the voters want. So it is up to us, the American people, to learn an important lesson from this latest episode. Just like someone who's had a heart attack and survives takes the warning seriously by going on a diet, exercising, and changing his lifestyle, so we must consider this deficit scare as a warning, too. We need to put ourselves on a fiscal diet by demanding from Government only what we are willing to pay for in the form of taxes. It won't happen overnight—nor should it; it's a long-term, not particularly appealing process. However, it may be our last chance. ■



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